THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

NUMBER 370 **APRIL 2004**

Drug addicts get only a temporary high. America's economy, addicted to asset appreciation and debt, is no different.

—*The Economist*, Feb. 26, 2004

GOING FROM BAD TO WORSE

In one of his books, economist Friedrich Hayek writes, *"On the whole, one can say that the practical value of statistical research and business forecasting depends primarily upon the soundness of the theoretical conceptions on which they are based. To decide upon the most important problems of the trade cycle remains the task of theory."*

Economic forecasts are abounding like never before, but all in all there is little or no more than barren number-crunching. Next quarter's or next year's rate of real GDP growth is the number at the center of interest. Apparently, it is taken for granted that everything else will take care of itself if that number is right. The main underlying consideration and presumption seems to be the extrapolation of the last movements in real GDP growth.

Apparently, the optimistic forecasts for the U.S. economy in 2004 rest mainly on the assumption that it gained sufficient momentum in last year's second half to be now in a sustainable recovery. Our immediate answer is that a sustained recovery, or more precisely a self-sustaining recovery, needs rather more than just momentum and quantity. Above all, it needs quality in terms of a well-balanced demand and output structure.

How healthy, in other words, is the current U.S. economic recovery? Looking for reasonable measures, we have searched past experience. As past letters explained in some detail, it is completely out of whack with all prior postwar recoveries.

First of all, past recoveries were all far superior in strength. During their first eight quarters after recessions, real GDP growth averaged overall 10.2%, or 5.1% per year. What's more, the recoveries occurred across all sectors of the economy, with private employment up a stellar 6.6%. Real wage and salary income surged 9%. Rates of increase during the same two years for other economic components were industrial production, 17.9%; nonresidential durable equipment, 21.4%; nonresidential structures, 4.8%; residential construction, 36.7%; and consumption, 9.9%.

Now, what were the growth rates following the 2001 recession? It is a difference like that between day and night. Employment is down 1%. Against the average increase of 6.6% during past postwar recoveries, this makes an overall difference of almost 8%. Real wage and salary incomes have been virtually flat, compared with an average increase of 9% in past recoveries. Equally flat has been industrial production, against an average rise by 17.9% in past recoveries.

Oddly, one U.S. economic aggregate has a far better reading than all the others, and that is real GDP. Over the two years since end-2001, it has grown by 5.3% overall. Measured from fourth quarter to fourth quarter, it was even 7.1%. Yet both numbers, too, badly lag the postwar average of 10.2%. But compared with the extremely poor performances of employment, income and production growth, real GDP growth has done a lot better. We must admit to having a hunch for its reason — creative measurement of the inflation rates.

In brief, compared to past experience, the U.S. economy's present recovery is manifestly an outright disaster. However, this fact is conveniently buried under the bullish mantra that the United States had its mildest recession — referring to the year 2001 — in the whole postwar period. Fed Chairman Alan Greenspan even boasts how successful his policy has been. On Jan. 3 at the meeting of the American Economic Association in San Diego he said:

There appears to be enough evidence, at least tentatively, to conclude that our strategy of addressing the bubble's consequences rather than the bubble itself has been successful. Despite the stock market plunge, terrorist attacks, corporate scandals, and wars in Afghanistan and Iraq, we experienced an exceptionally mild recession — even milder than that of a decade earlier. As I discuss later, much of the ability of the U.S. economy to absorb these sequences of shocks resulted from notably improved structural flexibility. But highly aggressive monetary ease was doubtless also a significant contributor to stability.

It should be clear that the mildness of the recession in 2001 has no relevance anymore. The most important question of all after three years of subpar economic growth is whether or not the conditions for a lasting economic expansion are finally in place.

In his testimony before the Congressional Committee on Financial Services, Mr. Greenspan said that he saw good chances for a sustained economic recovery:

The household sector's financial condition is stronger, and the business sector has made substantial strides in bolstering balance sheets. Narrowing credit risk spreads and a considerable rally in equity prices have reduced financing costs and increased household wealth, which should provide substantial support for spending by businesses and households. With short-term real interest rates close to zero, monetary policy remains highly accommodative. And it appears that the impetus from fiscal policy will stay expansionary, on net, through this year.

WHAT WENT WRONG?

For us, Mr. Greenspan is the great deluder of the American public, flatly deceiving it about the economy's true situation and prospects. His speeches always convey the impression of extraordinary sophistication, but the reality is that elementary knowledge of macroeconomic aggregates or processes, such as saving or wealth creation, obviously eludes him. It keeps amazing us how little critical response he finds.

One reason for this generally silent complacency, we presume, is an overwhelming desire among economists not to upset the prevailing bullishness of public opinion. Bear in mind that Wall Street economists dominate economic discussion in the United States. Their main concern is the stock market.

But we also note a widespread lack of knowledge or interest in macroeconomic matters even of crucial importance. Nobody cares about savings, nobody cares about a credit expansion that has gone completely out of control and nobody seems to realize that the huge trade deficit has been the greatest profit-killer in the U.S. economy for years. Rather, it is hailed as an emblem of economic strength.

The other looming danger in addition to the trade deficit, is, of course, the immense risk it poses to the dollar and in its wake to the whole financial system, both having become heavily hooked on incessant, immense capital inflows. It seems to us that this horrendous danger, too, is in general not at all appreciated.

Pointing to higher U.S. real GDP growth in America than in Europe and Japan, the bullish American consensus has been hailing Mr. Greenspan's aggressive monetary easing as a tremendous success. In our view, this comparison is heavily distorted by different calculations of inflation rates. Looking at the economic aggregates that truly matter for people and the economy, like employment, incomes, and production, the U.S. economy over the past three years has performed most miserably among the industrial nations.

What went wrong in the first place? Actually, it seems easier to first identify some factors that have plainly not been among its causes. It is the first economic downturn in postwar history that has not been precipitated by rising inflation and monetary tightening.

As aggregate domestic demand eventually outpaced aggregate domestic supply during past booms, inflation rates used to accelerate. The Fed then pulled the brakes, invariably culminating in recession. Monetary easing, starting about a year later, then promptly triggered the subsequent V-shaped upturn. Within just two years following the recession, the economic losses suffered during the recession were more than offset by very steep economic recoveries.

Periods of recession implicitly reflected the liquidation of the borrowing and spending excesses that had accumulated during the prior boom. In this way, businesses came out of recessions with strong balance sheets and great gains in efficiency.

The thing to see is that the borrowing and spending excesses that accumulate in the course of the boom essentially disrupt the economy's established pattern of demand, output, incomes, relative prices and profits. These distortions hamper economic growth directly over time, irrespective of the level of interest rates.

IT IS TRULY DIFFERENT, BUT FOR THE WORSE

Manifestly, both the U.S. economy's and the stock market's sharp downturns in 2000 were not caused by tight money or credit. Nonfederal credit rocketed in the year's second quarter when the two began their plunge at an annual rate of $1,315 billion. The increase during the year as a whole was $1,148 billion, after $1,098 billion the year before.

For comparison, during recession year 1991, the total nonfederal credit rose $188 billion, after $410 billion in 1990 and $632 billion in 1988.

Assessing the U.S. economy's prospects, we must first be clear about the extraordinary causes of the downturn that started in mid-2000. The consensus in America appears to regard lack of corporate pricing power, depressing profits and business investment, as the main causes. Talk of deflation has been abounding. This view, in other words, locates the cause of the economy's protracted sluggishness in the price system, not in the economy.

In our view, any talk of deflation in the face of the most rampant money and credit creation in history is utter nonsense. It would, in any case, require an explanation why so much of the runaway money and credit creation fails to go into the economy and its inflation rates.

Essentially, the explanation lies in identifying the uses to which the credit excesses were put. Principally, there are always three potential outlets for the spending both of earned and borrowed money: the economy, the asset markets and the balance of payments.

It is undisputed that the U.S. economy turned into a bubble economy in the later 1990s. Such an economy has its particular gist in sharply rising asset prices, which, in turn, provoke and foster specific extraordinary borrowing and spending excesses.

During Japan's bubble years in the late 1980s, the brunt of the bubble-related borrowing and spending excesses went overwhelmingly into business investment and commercial building. In America, by contrast, their overwhelming target has been and remains consumption and home building. Strikingly, this was already true for America's asset bubble in the late 1920s.

A more or less pronounced shift in the economy's demand and output pattern, fostered by the soaring asset valuations, is really the nub and the key problem of a bubble economy. In Japan's case in the late 1980s, the surging asset prices boosted personal consumption through wealth effects by a cumulative 2–4%, while the impact of capital cost effects on business investment has been as large as 10–12%.

Spectacular shifts in the economy's spending and output pattern are the highly visible features of a developing bubble economy. In the U.S. case, the borrowing and spending effects of the various asset bubbles since 1997 have gone completely into private consumption, as strikingly reflected in a steep rise of personal consumption as a percentage of GDP, and the related virtual collapse of personal savings.

TAKING MEASURE OF A BUBBLE

But the key measure to watch is really the credit numbers. Credit expansion in the United States went abruptly into extreme excess after 1996. Nonfederal, nonfinancial credit growth shot up from $584.7 billion that year to $1,094.6 billion in 1998, accompanied by a similar burst in financial credit from $550.1 billion to $1,084.6 billion.

Just as manifestly, this unfolding credit explosion went heavily into the stock market. Think of the merger and acquisition mania, and massive corporate stock buybacks. The signs of a credit-driven asset bubble and of its immense boost to consumer spending could not have been more obtrusive. In a speech at a central banker symposium at Jackson Hole, Wyoming, Mr. Greenspan nevertheless declared:

> *To anticipate a bubble about to burst requires the forecast of a plunge in the price of assets previously set by the judgment of millions of investors, many of whom are highly knowledgeable about the prospects for the specific companies that make up our broad stock prices.*

It was an utterly strange remark coming from a central banker. First of all, the central banker has to look at markets with a radically different perspective than investors and speculators. His task is to watch over macroeconomic balance and stability. From this perspective, asset bubbles as such do not matter. They become a central bank's problem only when they translate into borrowing and spending excesses. When that happens, a "bubble economy" develops.

From this perspective, Mr. Greenspan's remark about millions of investors failing to *"anticipate a bubble about to burst"* is completely beside the point. At issue are the various macroeconomic disruptions that the stock market bubble — through the correlated consumer borrowing and spending binge — has been implanting into the U.S. economy for years, thereby undermining its long-term stability and strength.

Even if it were arguable whether or not the stock market boom qualified as an "asset bubble," the crucial event was the developing, unprecedented consumer borrowing and spending excess that it fostered. On closer look, there were really two different, though tightly correlated, credit bubbles at work: one fueling the asset bubble, and another one translating the higher stock prices into higher consumer spending.

Though everybody was well aware of these underlying causal connections, Mr. Greenspan and the bullish Wall Street consensus only had eyes for the positive growth effect, as measured by the increase of real GDP, hailing it as a highly beneficial development. The associated heritage of exploding consumer debts, collapsing savings and a rocketing trade deficit found and still find zero attention.

It appears that American policymakers and also most economists have one single parameter for healthy, solid economic growth, and that is a coincidence of low or falling inflation rates and strong real GDP growth. The basic underlying idea is that low inflation rates are both the necessary and sufficient conditions for sustained economic and financial stability. From this perspective, the prolonged coincidence of strong economic growth and falling inflation rates in the United States was considered compelling testimony of outstanding economic health.

This high esteem of low inflation rates developed around the world during the 1970–80s in reaction to then soaring inflation rates. They came to be regarded as the top problem for every economy, and accordingly, restoration of lower inflation rates became the main target of central banks.

Well, this assumption has been tested during the past few years in the United States and exposed as a badly flawed assumption. Falling inflation rates misled the Greenspan Fed to accommodate unprecedented credit excesses that tore the economy grossly out of balance in many ways.

The legacy of this monetary policy has been there to see for more than three years: protracted subpar economic growth and in its wake by far the worst employment and income performance over the whole postwar period.

Contrary to widespread perception, America's boom of the late 1990s had its key prop not in high-tech investment, but in a wealth ecstasy propelling the greatest consumer borrowing and spending binge of all times. High-tech euphoria was crucial in rationalizing the bull run of the stock market and the associated wealth euphoria, but it did not cause the boom. For that, its share of GDP — around 4% — is far too small. The alleged high-tech boom mainly reflected hedonic pricing of computers.

Unmistakable and compelling evidence of the consumption excess was an unprecedented escalation of personal consumption as a percentage of GDP growth. Averaging about 77% between 1997–2000, this compares with a prior long-term average of 63%.

While U.S. economic growth, as measured by aggregate GDP, looked strong during those years, it disguised an extremely unbalanced pattern. Importantly, an increasing share of consumption essentially decreases the resources available for investment and foreign trade. In more colloquial language, the excess consumption crowded these two components out, particularly foreign trade.

AN OMINOUS PRECEDENT: 1927–29

Few people are probably aware that this extraordinary consumer borrowing and spending binge of the past few years has an ominous precedent in history. It also ushered in America's Great Depression of the 1930s.

According to the prevailing perception, America's boom of the 1920s was investment driven. It is one of several gross misconceptions about this period. Business investment, in fact, more than doubled from 1921 to 1926, but modestly declined thereafter. A slight recovery in 1929 brought it back to its level in 1926.

Two events governed the U.S. economy's sustained strong growth in the following two to three years: rapidly escalating stock prices and a rapidly escalating consumer borrowing and spending binge. A cut of the discount rate from 4% to 3.5% in August 1927 had given both of them a strong impetus. Within little more than two years, the major stock indexes for industrials more than doubled. Obviously, the sharply accelerating stock market boom was crucial in boosting consumer spending, after investment activity had slackened.

Put differently, the monetary stimulus went entirely into the stock market and installment credit for spending on consumer durables. The providers were not only the commercial banks, but also mushrooming nonbank lenders, all of them competing aggressively for consumer lending.

By the late 1920s, about 1,500 finance companies competed with thousands of commercial banks for a toehold in the consumer credit market. About 60% of all spending on durables was on big-ticket items, and some 70% of that was financed by consumer credit.

HYPERTROPHY OF CONSUMPTION

We all know how America's great consumption boom of the late 1920s ended in the Great Depression of the 1930s. What is generally known about its causes in America comes from economists Milton Friedman and A.J. Schwartz's *Monetary History* (1963). There the two argue *"that the monetary collapse from 1929 to 1933 was not an inevitable consequence of what had gone before. It was the result of the policies followed during those years."*

In their view, in other words, the economic collapse had its decisive cause in the monetary collapse that happened during these years: *"The monetary authorities could have produced any desired increase in the money stock."*

REAL GDP AND SELECTED COMPONENTS (BILLIONS OF 1929 DOLLARS)

	CONSUMPTION	GROSS INVESTMENT	CONSTRUCTION	GNP
1925	66.1	16.4	10.0	90.5
1926	71.5	17.1	10.7	96.4
1927	73.2	15.6	10.4	97.3
1928	74.8	14.5	9.8	98.5
1929	79.0	16.2	8.7	104.4
1930	74.7	10.5	6.4	95.1
1931	72.2	6.8	4.5	89.5
1932	66.0	0.8	2.4	76.4

SOURCE: KENDRICK, DEPARTMENT OF COMMERCE

Manifestly, the economy's sudden slump in 1931 had many particular causes. Consumption fell because wages and incomes fell, residential construction fell because the stock of housing was high, inventories fell because sales fell, business investment fell because profits fell, exports fell because the world economy weakened. Wages, profits and sales all fell because both consumption and investment fell.

But was there nothing that could reasonably be ranked as a primary cause? Trying to identify this primary cause, we look at what happened in

the two to three prior years — in the economy and in the financial system. It has always struck us that economic growth in the United States went grossly out of balance after 1926–27.

American policymakers and most economists regard and treat consumer spending as the most important component in assessing the economy's future. In this vein, it is widely opined that the unusually sharp fall of consumption after 1929 played a key role in initiating and establishing the Depression.

Our own reading, in line with Austrian theory, is very different. From this perspective, the maladjustments leading later to the Great Depression really started with the peaking of business investment and construction in 1926. From then on, investment spending slowly contracted.

Yet the economy kept up its strong growth until 1929 as accelerating consumer spending filled the investment gap on the demand side. When the consumer, too, drastically retrenched in 1930, business investment and residential building literally collapsed. The following joint plunge of consumer and business spending drove the economy into the prolonged Depression.

Using the vocabulary of the Austrian School, the decisive maladjustment during the three years 1927–29 was a major spurt in consumer spending in relation to investment spending. Loans to consumers soared while loans to producers plummeted.

In short, the economy's demand and output structure changed drastically in favor of consumption. In his lectures at the London School of Economics in 1931 (published in *Prices and Production*, 1931), economist Friedrich Hayek elucidated in great detail why such prolonged excess in consumer spending inexorably leads to economic depression over time.

It is, of course, the precise opposite of past and present conventional thinking in America, which presumes that higher consumption stimulates investment spending.

THE PROCESS OF CROWDING OUT

What is Hayek's explanation? Using first his own vocabulary: *a relative increase in consumer spending causes depression by bringing about a shortening in the process of production.* Translating this sentence into current colloquial language, it says: When consumption increases as a share of GDP, it crowds out investment spending.

In other words, a relative increase of consumption essentially implies a corresponding decrease in capital investment, which, in turn, curtails consumption by reducing wages and salaries of workers in the capital goods industries. Being a cumulative process, it needs more and more consumer borrowing to maintain consumer spending in the face of shrinking consumer incomes.

The most popular and most plausible counterargument has always been that such crowding out of investment need not be the case in an economy with large unused resources, as in the United States in 1930s, and as also at present.

But as Hayek rightly stressed, the damaging crowding-out process is prone to take place even then, working through the price mechanism. As the strong demand for consumers' goods and services boosts their prices relatively to those of producers and capital goods, satisfying consumers' demand promises higher profits. In essence, the economy's whole demand and output structure becomes increasingly lopsided toward meeting inflated consumer demand.

This is again the primary structural distortion that has gripped the U.S. economy for the past several years. Activity concerning the consumer has flourished; activity in the rest of the economy has been stalling. Business production and investment are guided by relative prices, and these, in turn, act adversely or positively on relative business profits.

A grossly distorted demand pattern in the United States has led to a grossly distorted profits pattern that makes a healthy, sustainable economic recovery, in our view, impossible. Our focus in this respect is mainly

on two major sectors: manufacturing (on the economy's supply side) and retail trade (on the economy's demand side).

In 1997, manufacturing earned $195.2 billion, as measured by National Income and Product Accounts (NIPA). This compared at the time with retail-trade profits of $63.9 billion. In the recession year 2001, manufacturing profits hit a low of $54 billion, while those of the retail trade made a new high of $71.1 billion.

During 2002 and 2003, manufacturing profits have sharply recovered to $97.7 billion at annual rate. Still, that was just half their level in 1997. Retail-trade profits rose further, to $84.3 billion.

The stock market bubble of the 1920s ended with an unprecedented consumption boom, and just that has been happening again since 1997, and in particular since 2001. Since then, consumer spending has accounted for 92% of GDP growth. Yet to keep it rising in the face of grossly lacking income growth, the Fed has invented a policy stance that has no precedent in history: boosting home prices with artificially low interest rates in order to provide rapidly growing collateral for consumer borrowing.

NEED FOR ADJUSTMENT

For the American consensus economists, the Fed's monetary ease over the last three years has been a great success. As a result, according to the general mantra, the U.S. economy did not suffer an economic slump of the kind that followed the stock market's crash in 1929. In one of his congressional testimonies, Mr. Greenspan actually emphasized that *"imbalances in the economy had not festered in the past years."*

Attempting to assess the economy's further outlook starts with the question of whether or not the economic and financial maladjustments that precipitated the economy's downturn in 2000 have been significantly remedied. To repeat the key point in this respect: Since this downturn was definitely not caused by tight money or credit, loose money alone cannot be the solution.

Earlier we identified the consumer borrowing and spending binge since 1997 as the U.S. economy's decisive primary maladjustment. It was crucial in generating the variety of dislocations and imbalances that broke the economy's vigor — the collapse of personal saving, the surge of the trade gap, the slump in business investment, the profit carnage, and exploding consumer and business debt loads.

In late 1929, the Dow plummeted from a September peak of 381 to a low of 199 on Nov. 13. But the market recovered quickly and sharply. By April 1930, the index had climbed back to 294 — up 48%. It actually recovered almost half of its prior losses.

By no means had the stock market crash of 1929 caused an immediate shock. Little more than a brief and mild economic setback was expected. The major changes for the worse in the economy occurred in the second half of 1930. As the stock market no longer delivered the capital gains that had given the necessary psychological and financial prop to consumer spending, it weakened rapidly.

This is, of course, the crucial difference between then and today. This time, the Fed succeeded in cushioning the impact of the bursting stock market bubble on consumer spending by rapid and drastic rate cuts that promptly fuelled a housing and bond bubble instead. The former created the soaring collateral values that facilitated sharply higher borrowing, while the latter served to slash borrowing costs.

For many observers, this was an ingenious new monetary policy. For sure, it prevented for the time being a sharper economic downturn. But it raises the last and most important question of all: Has it created the conditions that are requisite to put the U.S. economy on the road of lasting recovery?

To quote Hayek again on this question:

> *The thing which is needed to secure healthy conditions is the most speedy and complete adaptation possible of the structure of production to the proportion between the demand for consumers' goods and the demand for producers' goods as determined by voluntary saving and spending. If the proportion*

as determined by the voluntary decisions of individuals is distorted by the creation of artificial demand, it must mean that part of the available resources is again led into wrong direction and a definite and lasting adjustment is again postponed.

The credit excesses of the bubble economy implicitly disrupt its underlying structures of demand, output, relative prices and profits in many ways. The thing to realize is that these bubble-related maladjustments depress the economy of their own accord, as happened in the United States in 2000–01. In the same vein, restoring sustainable economic growth needs liquidation of the distortions that have accumulated in the economy and its financial system.

The two most important historical cases of boom and bust of a bubble economy were Japan in the late 1980s and the United States in the late 1920s. But Japan's bubble went overwhelmingly into business fixed investment and commercial building, while the U.S. bubble went completely into consumption. Past business cycles had their harmless and easily adjustable main imbalance in inventory excesses.

Again, it is hypertrophy of consumption in the U.S. bubble economy. But instead of stimulating production, it appears to have choked it off. Since 1997, personal consumption is up 43% in current dollars, and 38% in chained dollars. Industrial production, in contrast, has crept up just 10% over the same six full years.

In 2003, U.S. GDP grew in current dollars by $504.7 billion, or 4.8%, and in chained dollars by $314.7 billion, or 3.1%. This was achieved with a record-sized credit bubble of $2,717.5 billion. Consumers borrowed a record $879.9 billion, up about 10%, compared with a rise of current income by $281.3 billion, up about 2%.

SUCCESS OR FAILURE?

In the view of the bullish consensus, Mr. Greenspan has done a brilliant job in preventing a deeper and longer recession than might have been expected. This assessment, of course, ignores the protracted employment and income disaster. In our view, he has done a miserable job by papering over the existing maladjustments from the boom through even bigger, new bubbles and macroeconomic maladjustments, heralding much worse to come in the future. The structural damage to the economy has become far too big to still lend itself to a mild correction.

But there is a second major requirement of adjustment. It concerns the balance sheets both of consumers and businesses. Both have furiously ravaged their balance sheets during the bubble years by running up their debts out of proportion to income-earning assets. Have they repaired their balance sheets?

In his congressional testimony on July 15, 2003, Mr. Greenspan explained in some detail the many steps taken in the private sector to enhance the prospects for a resumption of strong economic growth by restructuring and strengthening their balance sheets. Here are some samples to taste:

Nowhere has this process of balance sheet adjustment been more evident than in the household sector. On the asset side of the balance sheet, the decline in longer-term interest rates and diminished perception of credit risks have provided a substantial lift to the market value of nearly all major categories of household assets. Most notably, historically low mortgage interest rates have helped to propel a solid advance in the value of owner-occupied housing stock…

On the liability side of the balance sheet, despite the significant increase in debt encouraged by higher asset values, lower interest rates have facilitated a restructuring of existing debt. Households have taken advantage of new lows in mortgage interest rates to refinance debt on more favorable terms, to lengthen debt maturity, and in many cases, to extract equity from their homes… Debt service burdens, accordingly, have declined.

Overall, during the first half of 2003, the net worth of households is estimated to have risen 4.5 percent — somewhat faster than the rise in nominal disposable personal income. Only 15 percent of that increase in wealth represented the accumulated personal saving of households. Additions to net worth have largely reflected capital gains from financial investment and from home price appreciation.

> *Significant balance-sheet restructuring in an environment of low interest rates has gone far beyond that experienced in the past.*

Mr. Greenspan was the most unreserved cheerleader of the market bubble. Plainly, he has learned absolutely nothing since then. Rather, he now glorifies asset bubbles as sources of wealth creation that allow and facilitate higher and higher consumer borrowing and spending.

WEALTH DESTRUCTION, NOT WEALTH CREATION

America's bullish consensus has decided to qualify rising asset prices as "wealth creation." This is unprecedented in economics. We asked 10 friends in Germany and France, all of them house owners and some of them completely illiterate in economics, whether they would feel richer if all house prices rose by 10%. The instant answer from all of them was, *"Of course not. Changing my home, I have to pay the higher price."*

At best, the house owners have avoided the general loss in purchasing power. But the gravest objections to the ruling perception of wealth creation arise from the macroeconomic perspective:

1. Traditional, genuine wealth creation occurs through two processes, both of them income-creating: *first*, through producing the desired capital goods; *second*, through their use after completion and installation. In essence, this wealth creation reflects capital formation within the economy.
2. America's new wealth creation takes place entirely outside the economy through rising market valuations of existing assets. Importantly, it involves neither asset creation nor income creation.
3. What in substance really happens is that the asset owners convert a part of their existing capital stock into higher consumer spending. In essence, this implies capital consumption and impoverishment, the precise opposite of wealth creation.
4. America's bubble economy is built on artificially low interest rates, pegged and orchestrated by the Fed.
5. Every asset and debt bubble inexorably ends in the bust of both.

This recognition is the main reason why we have always been more than skeptical of the optimistic recovery forecasts for the U.S. economy. Monetary and fiscal stimulus of unprecedented magnitude provided a temporary acceleration to real GDP growth, particularly in the second half of 2003. But in its most important task, to re-establish a desirable and sustainable consumption/savings/investment pattern, there has been total policy failure.

What about the second key condition for a lasting economic recovery, balance sheet repair?

According to Mr. Greenspan, as just cited, *"significant balance-sheet restructuring… has gone far beyond that experienced in the past,"* explaining in detail that this alleged extraordinary strengthening of balance sheets has derived exclusively from artificially low interest rates and asset inflation, fueled by his own reckless money printing. Adjusting balance sheets has in essence always meant that consumers and businesses stop and redress their spending and borrowing excesses of the boom. But in America, there has not been a trace of such adjustment. What Mr. Greenspan describes as successful balance sheet restructuring is the diametric opposite: borrowing and spending excesses driven to new extremes fostered by the loosest monetary policy in history.

ECONOMIC GROWTH THROUGH CONSUMPTION?

It is the traditional consensus opinion in the United States that stimulating consumer spending is the best way to stimulate investment spending by businesses. This assumption is supposed to be a reasonable legacy of economist John M. Keynes, as expressed in the so-called "acceleration principle." It says that changes in consumer spending induce corresponding changes in investment spending.

In this view, investment spending is "derived demand." Businesses invest when they see rising demand. And since consumer spending accounts for 60% to 70% and more of GDP, it appears to be the demand component that matters most for economic growth.

It is the greatest nonsense that has ever been invented in economics. In order to spend, the consumer must first earn the necessary money from employment. Consumer spending is primarily a function of income growth, and that, in turn, is a function of business production. The total sum of current incomes is determined by the total sum of production. America's employment growth has collapsed despite booming consumption.

In actual fact, Keynes never suggested that production comes from consumption. It is the invention of the early American Keynesians. He himself emphasized the exact opposite idea with the so-called "multiplier" concept — that changes in investment expenditures give rise to a multiple increase in overall spending, including consumption.

The two concepts are really not comparable. An increase in investment spending directly increases consumer incomes and consumer spending through the associated rise in the production of capital goods. Therefore, the old economists did not regard investment as an alternative to consumption, but as a source of consumer income.

In contrast, there is nothing in higher consumer spending that directly increases investment spending. Whether or not it indirectly stimulates investment spending obviously depends on many other conditions. Too much consumption may even crowd out investment spending.

American high esteem for consumption as the economy's engine of growth rather goes back to the 1920s. Remember, as described, the enormous role of consumer borrowing at the time. This pattern of thinking bore the imprint of three persons, of which the names of two went long ago into complete oblivion. One was the later President Herbert Hoover, and the other two — the scribblers, so to say — were Waddill Catchings and William Trufant Foster.

Between 1923–28 the latter pair published a series of economic books that became very popular in America, among them such titles as *The Road to Plenty, Profits* and *Business Without a Buyer*. In all these books they agitated for monetary inflation and public works. But what established their fame at the time was their proclamation that the highly productive industrial economies tend towards underconsumption.

The central problem of their investigation was the circulation of money between consumption and investment. They declared that money flows essentially start from spending on consumption goods. The main theme of all their books was, *"The one thing that is needed above all others to sustain a forward movement is enough money in the hands of consumers."*

So long as the process of investment is going on, no difficulty arises. The crisis sets in with the appearance of a surplus of production. Their proposed solution was this: *"It would be easy to arrange an increase in consumers' credits; it is only in this way that the deficiency in purchasing power of the consumer, and thus the cause of the Depression, can be removed."*

In essence, they pleaded for money creation through government and consumer credit. Credits to producers are undesirable because they aggravate *"still more the deficiency in the purchasing power of the consumer."*

European economists either ignored or ridiculed the writings of Foster and Catchings. Keynes wrote that *"their theories had at bottom some affinity to his own, but that they are not so close as might be supposed at first sight."*

In the United States, however, the pair gained enormous publicity and acceptance mainly for two reasons: The one was strong support by Herbert Hoover, and the other one was a most successful campaign that they launched with the explicit intent to convert economists by offering a prize for the best adverse criticism of their book *Profits*. An illustrious jury, among them America's top economists — Professor Wesley C. Mitchell and Owen D. Young, of Young Plan fame and president of General Electric — was to choose the best essay.

Among the authors of the essays were 50 professors of economics, 40 authors of books on economics, 60 accounting experts, bankers, editors, "some of the ablest men in the Federal Reserve," etc. A later published collection of the essays revealed that all authors, except two, had unreservedly accepted the main thesis of Foster and Catchings of an existing bias in the economy toward a chronic deficiency of consumer purchasing power. Any objections were directed against details.

A BADLY SCREWED RECOVERY

Now back to today's America. Pondering the U.S. economy's past and future performance, it is most important to keep in mind that its downturn and protracted subpar performance manifestly does not have its cause in tight money and credit.

Implicitly, something other than monetary obstacles has been hampering spending and production in the U.S. economy. As explained, the alternative culprits are major distortions and dislocations in the economy's pattern of domestic demand, output, relative prices and profits that have emerged from the credit excesses during the boom. Unfortunately, there is little sign that these causes are understood.

Putting on the monetary brake is always painful, but it is simultaneously instrumental in preparing the prerequisites for future economic growth. In diametric contrast, the Greenspan Fed has been fighting the deleterious outgrowth of past credit excess with new, even greater credit excess.

Focusing on real GDP growth, both the Fed and the bullish consensus claim a great policy success, sporting comparisons with slower growth in Europe. However, we have three big reservations about this comparison: *first*, Europe has abstained from demand stimulus; *second*, the GDP growth rates grossly lag those of past postwar recoveries in the United States; and *third*, there is an ominous, diametric discrepancy between GDP and employment figures.

Measured by its effect on employment, down half a percentage point since the end of recession in November 2001, it has been a policy disaster. In the 28 months following past postwar recessions, employment has, on average, grown by more than 7%. There is more truth in the employment numbers in our view than in the artificial GDP statistics.

The better look of the U.S. real GDP numbers has a major reason in persistent, significant understatement of U.S. inflation rates. It does not make sense that the United States — with exploding money and credit growth and a falling currency — has lower inflation rates than Europe — with far more moderate money and credit growth and a sharply rising currency.

Pondering the U.S. economy's further recovery, it has to be realized that its return to full-fledged growth depends intrinsically on the prior removal of the causes that keep depressing it. Priming the pump works only when the pump is in good order.

Earlier, we identified developing gross disproportions between consumption and investment as the underlying structural cause of the U.S. economy's disappointing performance. The fact is that the disproportion between the two aggregates has been going from bad to worse during the past three years. Since end-2000, real GDP is up 5.9%, consumer spending up 9.2%, thereof durables + 19%, and residential building up 13%. But nonresidential investment is down 8.7%. National savings are close to zero.

RUNNING OUT OF GAS

A more badly screwed-up recovery pattern is hardly imaginable. Moreover, these numbers definitely suggest the absence of pent-up consumer demand, which is inexorably needed for a sustained economic recovery. For various reasons, it is our long-held opinion that the U.S. economic recovery of 2003 would quickly run out of gas, even with negative real interest rates, once the big monetary and fiscal stimulus would abate.

Economic data definitely no longer show recovery vigor. Given the economy's weak performance in the fourth quarter, we suspect overstatement for the first quarter through seasonal adjustment. Despite record bullish sentiment, the stock market bubble is cooling, so much so that cheerleader Alan Greenspan felt obliged to encourage consumers to take on still more debt at lower variable rates. Considering that last year the U.S. consumer pocketed well over $1.1 trillion from tax cuts and new borrowings, it strikes us that the increase in his spending slightly slowed to 3.1%, from 3.4% in the year before. The income and spending numbers for January—February indicate sharply slower growth.

There is widespread hope that accelerating business investment, propelled by sharply higher profits, will join the rise in consumer spending. We doubt both parts.

Taking a closer look at the figures, we have great difficulty in sharing the general excitement. True, investment spending showed its first recovery in the second half of last year. But it was very narrowly based in high-tech spending. Spending in industrial and transportation equipment remained flat.

As to corporate profits, we have always focused on the component of the nonfinancial sector. It peaked in 1997 with $504.5 billion and bottomed at $318.8 billion in 2001. After a steady rise since then, they hit $453.2 billion, annualized, in the fourth quarter of 2003. In percentage, that is a steep increase. Measured against the growth in GDP, the improvement from the bottom turns out to have been rather moderate. In 1997, nonfinancial profits equaled 6.06% of GDP. In 2001, this share was down to 3.16% of GDP, and in the third quarter it was back up to 4%, still a very poor profit performance.

CONCLUSIONS:

Huge monetary and fiscal stimulus has fueled a temporary, phony U.S. economic recovery, but the associated debt explosion and its grossly maladjusted pattern make it unsustainable.

The virtuous circle of mounting production, employment and incomes never materialized.

Three years of the lowest real interest rates in history have definitely failed to generate enough traction for self-sustaining economic growth in the United States. Yet there remains absolute denial since there is very little or no understanding at all of the underlying causes.

The U.S. economy's basic malaise is reckless stimulation of asset bubbles and consumption, as against the virtual absence of capital formation. The trick has been to sell this as a brilliant and successful policy of economic growth.

It is a policy that has zero regard for adverse long-term consequences. Not one single credit- and debt-driven major asset bubble has ever ended in a "soft landing." America's bubble economy is the worst of its kind in history.

A sharply slowing U.S. economy may be the great surprise of 2004. It could well be the cataclysmic event that shakes the markets. Be prepared for plunging asset prices across the board, including bonds. Heavily leveraged carry trade of bonds, running into trillions of dollars, is the mother of all other bubbles.

THE RICHEBÄCHER LETTER

Dr. Kurt Richebächer, Editor
Published by Agora Publishing Inc.
Jeanne Smith, Publisher
Richard Barnard, Associate Editor
Emily K. Phillips, Editorial Assistant
Mark O'Dell, Graphic Design

For subscription services and inquiries, please write to: THE RICHEBÄCHER LETTER, 808 St. Paul Street, Baltimore, MD, 21202. Subscription orders may be placed toll free from inside the U.S. by calling (800) 433-1528, or from outside the U.S. by calling (203) 699-2900. Fax (410) 454-0403. Web: http://richebacher.com Subscription rates: in the U.S.: $497. Outside U.S.: $545. Published monthly.